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INTERNATIONAL COUNTERTRADE

Draft Legal Guide on International Countertrade Transactions

Report of the Secretary-General

Addendum

XI. LIQUIDATED DAMAGES AND PENALTY CLAUSES

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[Editorial note: The present draft chapter is a revision of draft chapter XI, "Liquidated damages and penalty clauses", published as document A/CN.9/WG.IV/WP.51/Add.3*. The note in square brackets at the beginning of each paragraph indicates either the number under which the paragraph appeared in document A/CN.9/WG.IV/WP.51/Add.3* or that the paragraph is new. The revisions of paragraphs that appeared in document A/CN.9/WG.IV/WP.51/Add.3* are underlined.]

A. General remarks

1. [1] Liquidated damages clauses and penalty clauses provide that a failure by a party to perform a specified obligation, or a failure to perform it on time, entitles the aggrieved party to receive from the party failing to perform a sum of money agreed upon at the time the parties establish their contractual relationship. The agreed sum may be intended to stimulate performance of the obligation, or to compensate for losses caused by the failure to perform, or both. 1/ Sometimes, the parties agree that the obligation to pay liquidated damages or a penalty is to be secured by a guarantee (see below, paragraph 27).

2. [2] This chapter focuses on liquidated damages and penalty clauses included in countertrade agreements to cover a failure to fulfil the countertrade commitment. The chapter does not address directly the use of liquidated damages or penalty clauses to support performance of supply contracts that form part of a countertrade transaction. Liquidated damages and penalty clauses are frequently used in sales contracts and other types of supply contracts, and the presence of such clauses in supply contracts that form part of a countertrade transaction does not raise issues specific to countertrade. Nevertheless, the discussion in this chapter of the general characteristics of liquidated damages and penalty clauses is relevant to the use of such clauses in supply contracts.

3. [new paragraph] Often the intention of the parties is for the clause to cover non-fulfilment of the countertrade commitment, i.e., that the beneficiary of the clause, by claiming the agreed sum in the case of breach of the countertrade commitment, would forsake fulfilment of the commitment. Sometimes the parties intend the clause to cover delay, i.e., that the countertrade commitment remains outstanding despite payment of the agreed sum (see below, paragraphs 13 to 16).

4. [3] The obligation to pay the agreed sum arises when the committed party fails to take the action specified in the countertrade agreement as necessary to fulfil the countertrade commitment. As discussed in chapter IV, paragraphs 35 and 36, that action may be either the conclusion of a supply contract or a specified action to be taken to perform the supply contract (e.g., opening the letter of credit or delivery of goods). If the countertrade commitment is to be fulfilled upon performance of the supply contract, failure to render the performance in question may give rise to liability under both the liquidated damages or penalty clause in the countertrade agreement as well as under the supply contract, a duplication of remedies the parties may wish to avoid (see chapter IV, paragraph 36).

5. [4] The purchaser's commitment to purchase goods may be covered by a liquidated damages or penalty clause in the countertrade agreement, as may be the supplier's commitment to make goods available. The clause may cover the whole or only a part of the countertrade commitment. In many countertrade transactions it is only the party who has exported and is committed to counter-import whose commitment is covered by such a clause. That is because that party may be primarily interested in exporting its own goods and may not have the same degree of interest in purchasing goods in return. However, when the party committed to purchase has a particular interest in obtaining the goods, it may be agreed that the party committed to supply the goods would pay an agreed sum in the event that the party committed to supply fails to conclude a supply contract. When both the party committed to purchase and the party committed to supply have a strong interest in the future conclusion of a supply contract, it may be agreed that the commitments of both parties are to be subject to a liquidated damages or penalty clause.

6. [5] When it is agreed at the time of conclusion of the countertrade agreement that a party should be entitled to monetary compensation if the other party fails to fulfil the countertrade commitment, an agreement on liquidated damages or a penalty has certain advantages. Firstly, the sum constitutes agreed compensation for such a failure, thereby allowing the parties to avoid the difficulties and expenses that might be involved in proving the extent of resulting losses. Those expenses might be considerable, especially if the aggrieved party had to establish the losses in judicial or arbitral proceedings. Furthermore, the amount of damages that might be awarded in judicial or arbitral proceedings may be uncertain (see chapter XIII. "Failure to complete countertrade transaction", paragraph 12). An agreed sum is certain, and this certainty may be of benefit to both parties in assessing the risks to which they are subject under the countertrade agreement. Secondly, the agreed sum may serve as the limit to the liability for a failure to fulfil the countertrade commitment. The party whose commitment is covered by the clause is assisted by knowing in advance the maximum liability likely to be incurred in the event of its failure to fulfil the countertrade commitment (see, however, the discussion below in paragraph 12, as to the possibility of a claim for damages in excess of the agreed sum). However, a liquidated damages or penalty clause may be a less attractive option when a purpose of the countertrade transaction is to avoid a transfer of currency.

7. [6] Many legal systems have rules regulating liquidated damages and penalty clauses, and those rules will often restrict what the parties may achieve through those clauses. Under some legal systems, clauses fixing an agreed sum to stimulate performance are invalid, and the party who fails to perform is liable only for the damages recoverable under the general law. Those legal systems recognize only clauses by which the parties, at the time of contracting, fix an agreed sum payable as compensation for losses caused by a failure to perform. Under other legal systems, however, clauses fixing an agreed sum payable as compensation, or fixing an agreed sum to stimulate performance, or fixing a sum which has both those purposes, are in principle valid. The courts may have the power to reduce the agreed sum in specified circumstances, in particular if the amount is grossly excessive in the circumstances or if there has been part performance. The courts may also have the power to award additional damages when the actual damages exceed the agreed sum. In those legal systems the parties may not be permitted to derogate from the power of the court to reduce the agreed sum or to award additional damages.

8. [7] A committed party may fail to fulfil its countertrade commitment due to a permanent or temporary impediment for which it is not responsible (for a discussion of such impediments, see chapter XIII, "Failure to complete countertrade transaction", paragraphs 13 to 36). The rule in many legal systems is that the agreed sum is not due if the failure to perform the obligation in question is caused by a permanent impediment for which the obligated party is not responsible. Such an approach is consistent with the rule on exemption from liability for failure to perform found in the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980), article 79 (see also Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, article 5 (see note 1)). If an impediment prevents performance of an obligation only temporarily, according to a rule found in many legal systems, the time period for performance of the obligation is extended. In the case of temporary impediments, payment under the liquidated damages or penalty clause would be due only for the countertrade commitment remaining unfulfilled after the lapse of the extended fulfilment period. The countertrade agreement may maintain the applicability of those rules and may contain provisions defining exempting impediments and providing a rule for determining when an impediment is deemed permanent (see chapter XIII, "Failure to complete countertrade transaction", paragraphs 17 to 34).

9. [8] Liquidated damages or penalty clauses should be distinguished from two other types of clauses, i.e. clauses limiting the amount recoverable as damages, and clauses providing alternative obligations. A clause limiting the amount recoverable as damages fixes a maximum amount payable if liability is proved. A plaintiff must prove the amount of its losses, and, if the amount falls below the maximum, only the amount proved is recoverable. In the case of liquidated damages or penalty clauses, the agreed sum is recoverable without proof of loss. A clause providing an alternative obligation gives the obligated party the option either of performing a specified obligation or paying an agreed sum. By exercising either option, the obligated party discharges the obligation. Under liquidated damages or penalty clauses, the obligated party does not have the option of choosing between either performing the obligation or paying the agreed sum. If there is any doubt as to whether it is intended that the committed party would have such an option, it is advisable that the question be settled in the clause.

10. [9] Clauses discussed in this chapter should also be distinguished from provisions in countertrade agreements establishing the obligation to liquidate through cash payments imbalances in the flow of trade in barter contracts or where countervailing claims for payment are to be set off. Such payments to liquidate imbalances serve the function of payment for goods delivered in one direction that were not compensated by deliveries in the other direction. Furthermore, the amounts of such payments are not set in advance as is the case with liquidated damages or penalties. (For a discussion of clauses concerning the settlement of imbalances in barter, see chapter III, "Contracting approach", paragraph 7, and in setoff arrangements, see chapter IX, "Payment", paragraphs 54 to 57.)

11. [10] As discussed in chapter VIII, "Participation of third parties", the countertrade party committed to purchase or to supply goods may have the right to engage a third party to fulfil that commitment. In some of those

cases, it is agreed that the party originally committed is to remain liable for fulfilment of the countertrade commitment. When this is the case, the contract by which the third party is engaged may provide that the third party is to pay liquidated damages or a penalty to the party originally committed in the event of a breach of the third party's commitment to purchase or to supply goods. The purpose of payment of the agreed sum would be to indemnify the party originally committed for its liability for a breach of the countertrade commitment due to reasons imputable to the third party. The indemnification by the third party of the party originally committed could also take the form of a "hold-harmless" clause of the type discussed in chapter VIII, paragraph 37. Any commitment to conclude future supply contracts that is made by the third party directly to the countertrade party with whom those supply contracts are to be concluded may also be covered by a liquidated damages or penalty clause. (For a related discussion of the engagement of third parties, see chapter VIII, paragraphs 6, 17 and 18 (third-party purchasers), and paragraphs 49 to 51 (third-party suppliers)).

B. Relationship of recovery of agreed sum to recovery of damages

12. [11] Legal systems often regulate the relationship between the recovery of the agreed sum and the recovery of damages. Since one of the objectives of a liquidated damages or penalty clause is to avoid the difficulties of an inquiry into the extent of recoverable damages (see above, paragraph 6), under some legal systems the party to whom the agreed sum is owed is not permitted, in cases where recoverable damages under the rules relating to damages exceed the agreed sum, to waive the agreed sum and claim damages. Nor is the party owing the agreed sum permitted, in cases where the amount recoverable as damages is less than the agreed sum, to assert that that party should only be liable for damages. Under other legal systems, however, the party to whom the agreed sum is owed is permitted to prove that the losses exceed the agreed sum. In those legal systems the aggrieved party can, in addition to the agreed sum, recover damages to the extent that the loss exceeds the agreed sum, either unconditionally or subject to satisfying certain conditions (for example, that the failure of performance was negligent, or was committed with an intention to cause loss, or that there was an express agreement that damages for the excess are to be recoverable). In view of such disparities among legal systems, and the differing perspectives from which a liquidated damages clause may be interpreted, it is advisable that the parties, to the extent permitted by the applicable law, settle in the clause the question whether the aggrieved party would be entitled to any damages beyond the agreed sum (Uniform Rules, article 7 (see note 1)). (For further discussion of monetary compensation for failure to fulfil the countertrade commitment, see chapter XIII, "Failure to complete countertrade transaction", paragraphs 11 and 12.)

C. Effect of payment

13. [12] An important question for the parties to consider is whether, by claiming the agreed sum, the beneficiary of the clause forsakes fulfilment of the underlying obligation. Often the intention of parties to countertrade transactions is that the beneficiary who, in the case of breach of the countertrade commitment, chooses to claim the agreed sum is precluded from also claiming fulfilment of the countertrade commitment. However, since

sometimes the parties intend that the agreed sum is to be payable for delay in fulfilment of the countertrade commitment, in which case the countertrade commitment remains outstanding despite payment of the agreed sum, it is advisable for the liquidated damages or penalty clause to contain a clear provision on the effect of payment of the agreed sum. In the absence of such a provision, the effect of payment would be determined by the applicable law and on the basis of circumstances that indicate the intent of the parties (e.g., the amount of the agreed sum) (Uniform Rules, article 6 (see note 1)).

14. [new paragraph] It should be noted that the nature of the obligation in question may determine whether performance could be enforced. In particular, performance of an obligation to provide services might be unenforceable under the laws of some States, thereby leaving compensation through monetary damages as the remedy.

15. [13] The parties may wish to provide for payment of an agreed sum for delay when it is particularly important for the countertrade commitment to be fulfilled by a specified date or for portions of the countertrade commitment to be fulfilled according to an agreed time schedule. The supplier may be interested in such a clause, for example, when the timely fulfilment of the countertrade commitment in one direction is essential for its ability to meet its payment obligations under the supply contract in the other direction. The purchaser may be interested in such a clause, for example, when a commitment has been made to resell the goods by a particular date. The amount of the agreed sum payable for delay is further discussed below in section D.

16. [14] The question of the effect of payment of an agreed sum would also arise when payment is due for a failure to fulfil the portion of a countertrade commitment allocated to a subperiod of the fulfilment period. In such cases it is advisable to make clear whether any payment is due under the liquidated damages or penalty clause for any unfulfilled portion of the countertrade commitment that is not carried over or that remains unfulfilled upon the expiry of the overall fulfilment period, or whether any payment is due for any unfulfilled portion of the countertrade commitment that is carried over from one subperiod to the next.

D. Amount of agreed sum

17. [15] The amount of the liquidated damages or penalty, whether stipulated for non-fulfilment or for delayed fulfilment of the countertrade commitment, may be expressed as an absolute amount or as a percentage of the value of the outstanding commitment. Calculating the amount on the basis of a percentage of the outstanding commitment has the advantage of automatically reducing the amount as the countertrade commitment is fulfilled. If there is an independent guarantee to secure payment of the agreed sum (see below, paragraph 27), in view of its independent nature, any reduction of the amount that might become due would not result in an automatic reduction of the amount of the guarantee. Therefore, in order to keep the amount of the guarantee in line with the underlying obligation, it is advisable for the terms of the guarantee to provide that any reduction in the countertrade commitment is to result, upon presentation of agreed documents, in a corresponding reduction in the amount of the guarantee (see chapter XII, "Security for performance", paragraphs 25 and 26). In the case of an accessory guarantee, a reduction in the underlying obligation would result in an automatic reduction of the amount owed under the guarantee (see chapter XII, paragraph 3).

18. [19] When the clause for the payment of liquidated damages or a penalty covers delay, an agreed sum to be paid is often fixed by way of increments, a specified amount being due for a specified time unit of delay. In such cases it is advisable that a limit be placed on the cumulative amount of the increments. The parties may wish to address the possibility that the failure to fulfil the commitment would continue after the limit is reached. One approach would be to provide that the beneficiary of the liquidated damages or penalty clause is not entitled to recover either further increments in the liquidated damages or penalty, or damages for losses suffered as a result of non-fulfilment of the countertrade commitment after the date on which the limit was reached. Under another approach, after the limit is reached, the beneficiary of the liquidated damages or penalty clause is still entitled to claim fulfilment of the commitment. In this case the parties may agree that if the committed party fails to fulfil the countertrade commitment within an agreed period after the cumulative limit has been reached, the beneficiary of the liquidated damages or penalty clause is entitled to claim an additional agreed sum for non-fulfilment of the commitment. Under either approach it is advisable to provide that the beneficiary of the liquidated damages or penalty clause is entitled to terminate the countertrade commitment once the cumulative amount of the payments for delay is reached.

19. [16] Determining the appropriate amount for the agreed sum presents certain difficulties. In a long-term countertrade transaction, it may be difficult to estimate at the time of the conclusion of the countertrade agreement the losses that may be suffered at the time of a breach of the countertrade commitment, and accordingly it may be difficult to quantify the amount of the agreed sum that would make it either truly compensatory, or adequate to stimulate performance. From the point of view of the beneficiary of the liquidated damages or penalty clause, the agreed sum should not be fixed at such a low level that the beneficiary will suffer serious uncompensated losses upon a failure of the other party to fulfil the countertrade commitment. Furthermore, a sum that is less than what the obligated party would save by failing to fulfil the countertrade commitment would not serve as a stimulus to fulfil properly and on time. Indeed, it may serve as a stimulus not to do so. [the following sentence is a revision of the first sentence in paragraph 18 in A/CN.9/WG.IV/WP.51/Add.3*] The beneficiary of the clause may find it useful to have the agreed sum set at a level that provides both reasonable compensation and, to the extent permitted by the applicable law, a moderate pressure to fulfil the commitment.

20. [18] Excessive sums should be avoided, as they may deter some potential trading partners from entering into a countertrade agreement. Excessive sums may also make it more difficult to find a third party willing to become involved in the fulfilment of the countertrade commitment subject to a "hold-harmless" clause (see above, paragraph 11, as well as chapter VIII, "Participation of third parties", paragraph 37). An excessive sum may also have no special deterrent effect if it can be predicted that in all likelihood it will be declared invalid or reduced in legal proceedings (see above, paragraph 7). Furthermore, a party committed to purchase goods and requested to accept an agreed sum set at a particularly high level may as a counterbalance seek a lower price for the goods that party is to purchase, or that party may seek a higher sale price for its own goods.

21. [18] Where the applicable law only permits an agreed sum to serve as compensation, parties should attempt to estimate as accurately as possible the losses the purchaser is likely to suffer. [the following sentence is a revision of paragraph 17 in A/CN.9/WG.IV/WP.51/Add.3*] The parties should bear in mind that, under such laws, the amount of the agreed sum might be viewed by a court as an important factor in determining whether the obligation to pay the agreed sum was intended to compensate for damages or to stimulate performance (see above, paragraph 7). Any records relating to the basis of the estimate and the calculations should be preserved as evidence that the sum was not fixed arbitrarily. In addition, the parties may wish to include a statement in the countertrade agreement that the amount set in the clause represents a good faith estimate of the damages that would be suffered as a result of a breach of the countertrade commitment.

22. [18] In determining what sum is reasonable for an agreed sum to cover non-fulfilment of the countertrade commitment, parties may consider such factors as the price the supplier would obtain in a substitute sale, the price the purchaser would have to pay in a substitute purchase, losses that might result from non-fulfilment of the countertrade commitment, the extent of the risk that the countertrade commitment will not be fulfilled and the fact that the sum should be substantial enough to induce performance.

23. [new paragraph] In determining what sum is reasonable for an agreed sum to cover delay in fulfilment of the countertrade commitment, parties may take into account circumstances that influenced the decision to include a liquidated damages or penalty clause in the countertrade agreement (see above, paragraph 15). For example, if the importer relies on timely counter-exports for repaying a bank loan, the basis for setting the amount of the agreed sum may be the financing costs that would have to be incurred as a result of late purchases under the countertrade agreement. If the counter-importer is to be the beneficiary of the liquidated damages or penalty clause, a relevant factor may be the consequences the counter-importer would face due to its inability to resell the countertrade goods by a particular date.

E. Obtaining agreed sum

24. [20] The parties may wish to provide that the aggrieved party loses the right to claim the agreed sum if a claim is not made within a specified period of time following the expiry of the fulfilment period (e.g., thirty days). The purpose of such a provision is to resolve questions of liability for a failure to fulfil the countertrade commitment within a reasonable period of time following the expiry of the fulfilment period. The period of time for making a demand should be sufficient to permit the parties to determine whether fulfilment of the countertrade commitment has taken place. This would be of particular importance where actions fulfilling the countertrade commitment might be taken shortly before the close of the fulfilment period or where supply contracts are to be concluded with persons other than the party to whom the commitment is owed.

25. [21] In the case of a fulfilment period divided into subperiods, it is advisable that the countertrade agreement indicate whether payment of the agreed sum is due following each subperiod in which there has been a failure to fulfil or only at the end of the entire fulfilment period. If payment is due following each subperiod, a period of time following the expiry of each subperiod could be provided during which payment of the agreed sum could be claimed (see the preceding paragraph).

26. [22] Legal proceedings that might be necessary to recover the agreed sum entail time and expense. The need to institute legal proceedings may be reduced if the countertrade agreement authorizes the beneficiary to deduct the agreed sum from funds of the other party in the hands of the beneficiary or to set off the claim for the agreed sum against funds due by the beneficiary to that party. For example, when it is agreed that the proceeds of the export contract are to be held to pay for the counter-export contract, it may be agreed that the counter-exporter may withhold an amount equivalent to the agreed sum if the counter-importer fails to honour its commitment to enter into a contract for the purchase of counter-export goods (see chapter IX, "Payment", paragraphs 12 and 62). Where the beneficiary of the liquidated damages or penalty clause does not retain the proceeds of a shipment in such a manner, the objective of securing payment of the agreed sum may be achieved by authorizing deduction from funds or claims that are unrelated to the countertrade transaction in question. It may be noted, however, that under some legal systems provisions authorizing deductions and setoff are regulated by mandatory rules. One such rule found in the laws of a number of States is that a setoff is permitted only if the claims to be set off arose from the commercial relationship between the parties. Furthermore, a deduction or a setoff might later be invalidated if the agreed sum deducted or set off was held by a court to be excessive, and was reduced.

27. [23] The beneficiary of the liquidated damages or penalty clause may wish to include a provision in the countertrade agreement requiring the other party to arrange for a financial institution to give a guarantee in respect of the agreed sum. The beneficiary could then claim the agreed sum from the financial institution according to the terms of the guarantee. Such guarantees are typically of an independent nature, although the possibility of using an accessory guarantee is not excluded. For a discussion on independent guarantees, their distinction from accessory guarantees and on possible payment terms of guarantees, see chapter XII, "Security for performance", in particular paragraphs 3, 4 and 18.

F. Termination of countertrade commitment and clauses for payment of agreed sum

28. [24] Parties may wish to provide that, where an agreed sum for delay is payable by way of increments with a limit on the cumulative amount recoverable (see above, paragraph 18), the countertrade commitment may not be terminated until the limit is reached on the ground of the failure to fulfil for which the agreed sum is provided.

29. [25] The parties may also wish to provide that termination after the limit is reached is not to affect any obligations to pay liquidated damages or penalties that became due prior to the termination. This would avoid the ambiguity that may result due to the rule in some legal systems that the termination of a contract affects obligations that became due prior to the termination of the contract. If, however, the countertrade commitment is terminated before the limit is reached (e.g., when the beneficiary of the liquidated damages or penalty clause terminates the countertrade commitment for a failure other than the one for which the agreed sum has been stipulated), the parties may wish to provide that the termination does not affect the right to recover an agreed sum due on the date of termination, but that no amount becomes due as the payment of an agreed sum after the termination.

Note

1/ Studies on the nature and operation of liquidated damages and penalty clauses in international contracts are contained in Yearbook of the United Nations Commission on International Trade Law, volume X: 1979, part two, I, C, and ibid., volume XII: 1981, part two, I, B, 1. "Uniform Rules on Contract Clauses for an Agreed Sum due upon Failure of Performance" (hereinafter referred to as "Uniform Rules") adopted by the Commission are set forth in the Report of the United Nations Commission on International Trade Law on the work of its sixteenth session, Official Records of the General Assembly, Thirty-eighth Session, Supplement No. 17 (A/38/17), annex I (also reproduced in Yearbook of the United Nations Commission on International Trade Law, volume XIV: 1983, part one, I, A). By its resolution A/RES/38/135 of 19 December 1983, the General Assembly recommended that States should, where appropriate, implement the Uniform Rules in the form of either a model law or a convention. The Uniform Rules may be used by parties in drawing up liquidated damages and penalty clauses.